STOCK TRANSACTIONS – TAX ISSUES
(INCLUDING THE GAIN EXCLUSIONS UNDER SECTION 1202 AND SECTION 1045)

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This outline was completed on October 3, 2016 and does not reflect developments after that date.

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1. WHAT'S THE BEST STRUCTURE TAX-WISE FOR EXITING A BUSINESS?

From best to worst:

1.1 Sale of C corporation stock when the 100% gain exclusion in Section 1202 applies – Zero tax on the sale. Careful, long-term planning needed to protect the Section 1202 exclusion. No AMT preference for stock acquired after September 27, 2010.[1] Tax-free reorg available as a back-up.

1.2 Sale of C corporation stock to which a partial gain exclusion would apply under Section 1202, followed by reinvestment in other "qualified small business stock." Zero tax on the sale. Careful, long-term planning needed to protect eligibility for the Section 1045 rollover.[2] No liquidity and continued concentration in one asset. No AMT preference. Tax-free reorg available as a back-up.

1.3 Sale of C corporation stock to an ESOP (sponsored by the corporation) in a Section 1042 transaction – Possible zero tax on sale. no gain on sale of shares if sale proceeds rolled into securities of U.S. companies,

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[1] See *Using Section 1202 to Eliminate or Reduce Tax on the Sale of C Corporation Stock* below at page 4.

[2] See *Section 1045 Exclusion and Rollover* below at page 28.

carryover basis; margin loans available to tap the cash; step up in basis at death escapes any tax. Capital gain on boot or sale of the U.S. securities. Requires feasibility study and annual appraisal and administration costs. Sale of all shares might require several years. Tax-free reorg available as a back-up.

1.4 Exchange of target[3] stock for buyer stock in a tax-free reorganization – No tax on exchange for stock, if strict rules are satisfied. Seller's basis in buyer stock equals seller's basis in exchanged target stock. Seller loses control of the business and still has a concentrated, undiversified investment. Cash, if any, received by seller in the exchange is generally taxed as capital gain. Buyer has a carry-over basis in the target's assets. Buyer uses newly issued shares and not cash for acquisition.

1.5 Sale of S corporation stock – One level of tax. All gain taxed as capital gain, installment sale treatment available. Undistributed S corporation income will have increased share basis, decreasing gain on sale. Section 336(e) or 338(h)(10) election (discussed below) and tax-free reorg available as back-ups.

1.6 Sale of C corporation stock when no Section 1042, 1045 or 1202 exclusion is available. One level of tax. All gain taxed as capital gain, installment sale treatment available. Basis in shares might be tiny. Tax-free reorg available as a back-up.

1.7 Sale of S corporation stock with a Section 336(e) or 338(h)(10) election – One level of tax. Treated as sale of assets, so ordinary income on gain from cash method receivables, on inventory and depreciation recapture; capital gain (taxed at low federal rates) on sale of goodwill. Big tax benefit to buyer, who might gross up the price to cover the ordinary income. Installment sale method available for income other than depreciation recapture. Tax-free reorg available as a back-up.

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[3] The "target" is the corporation that owns the business that is being sold.

1.8 Sale of assets by S corporation – One level of tax. Ordinary income and capital gain as noted above for sale of S corporation stock with a Section 338(h)(10) or 336(e) election. Sales tax likely without pre-sale planning. Installment sale method available for income other than depreciation recapture; with proper planning, distribution of installment note does not trigger tax on deferred gain. Tax-free reorg available as a back-up.

1.9 Sale of interest in multi-member LLC or partnership – One level of tax. Ordinary income and no installment method to the extent the sale price is allocable to income from providing services and inventory. Capital gain and installment method available for rest of price. Often difficult to achieve a tax-free combination as a back-up.

1.10 Sale of assets by multi-member LLC or partnership – One level of tax. Possibly the same as a sale by an S corporation, without the California entity tax. Gain might be allocated to the "partner" who contributed the assets sold. Often difficult to achieve a tax-free combination as a back-up.

1.11 Sale of assets by C corporation followed by a liquidating distribution to which the Section 1202 exclusion applies – One level of tax.[4] Corporate tax rates apply to gain on all assets, including goodwill. Sales tax likely without pre-sale planning. Installment sale method available for income other than depreciation recapture, but distribution of installment note triggers the deferred gain. Tax-free reorg available as a back-up.

1.12 Sale of stock by C corporation and buyer makes a "straight" Section 338 election (aka a "Section 338(g) election") – One level of tax. Treated as stock sale to seller, followed by a dissolution of the corporation by the buyer (triggering "inside" gain, resulting in a higher basis in the assets for the buyer and permitting the buyer to amortize good-

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[4] See *Using Section 1202 to Eliminate or Reduce Tax on the Sale of C Corporation Stock* below at page 4.

will over 15 years). Rare. Usually makes sense only for targets with big NOLs to absorb the gain. Tax-free reorg available as a back-up.

1.13 Sale of assets by C corporation – Two levels of tax. Corporation pays tax on "inside" gain from sale. Shareholders pay tax on distribution of after-tax sale proceeds. "Outside" transaction is capital, with application of basis if the corporation elects to dissolve. "Outside" transaction is dividend with no application of basis if not. Tax-free reorg available as a back-up.

2. USING SECTION 1202 TO ELIMINATE OR REDUCE TAX ON THE SALE OF C CORPORATION STOCK

2.1 Gain on the sale or exchange of qualified small business stock issued after 2010 is excluded from *both* federal regular tax *and* federal alternative minimum tax.[5] Up to $10 million in gain can be excluded for a single corporation.[6]

2.1(a) As a consequence, in a stock sale there would be no gain to the seller.[7]

2.1(b) In a sale of assets followed by a liquidation of the seller corporation, there would be one level of tax – on the "inside" gain.[8]

2.1(c) There is currently no corresponding California provision.[9]

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[5] For the partial exclusion for shares acquired after February 10, 1993 and before September 28, 2010, see Section 2.2(f) below.

[6] See Section 2.6 below.

[7] But see text at footnote 53 below.

[8] When a corporation distributes money or property to its shareholder while the corporation is in the process of liquidating, the distribution is treated as gain to the shareholder. I.R.C. § 331. The amount realized is the value of the assets distributed on the date of the distribution. I.R.C. § 301(b).

2.1(d) For the tax return preparer, it is important to document and appropriately report the exclusion.[10]

2.2 An overview - Making sense of the confusing structure of Section 1202

2.2(a) Every rule in Sections 1202 (and, to a lesser extent, Section 1045) is subject to exceptions and exceptions to the exceptions. It reflects political give and take (rather than logic or economics) in every line. So intuition is not helpful because there are no overriding principles from which to infer. There are several very similar defined terms.[11] Section 1045 defines "small business stock" in a way that is different than the definition in Section 1202. Some rules apply when the stock is issued, others during the time the taxpayer held the shares, others at the date of disposition. Because a huge amount of gain can be excluded – but only if the taxpayer can prove that the taxpayer and the corporation satisfied the requirements at several

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(footnote continued from previous page)

[9] So Section 1202 applies for federal income tax purposes only. Cal. Rev. & Tax. Code § 18152. Section 18152.5 of the Revenue and Taxation Code was a corresponding provision that expired on December 31, 2015. Cal. Stat. 2013, chapter 546, Section 2. The 1998 version of this statute was held to violate the commerce clause of the U.S. Constitution because it allowed the partial exclusion "only if the stock sold and purchased was issued by corporations that used 80 percent of their assets in the conduct of business in California and that maintained 80 percent of their payrolls in California." Cutler v. Franchise Tax Bd., 208 Cal. App. 4th 1247 (2012).

[10] See Section 2.8 below (Reporting the Exclusion) and Appendix A, *Documenting a Section 1202 Exclusion or a Section 1045 Rollover*.

[11] "Qualified small business stock," "qualified small business," and "qualified trade or business." None of these are the same as a "small business corporation" which can make an S corporation election. I.R.C. § 1361(b)(1).

points in time, a monumental amount of records need to be collected and kept in case of an audit.[12]

◊ The Treasury Department and the IRS have issued one short regulation under each Section. Although IRS gets many calls about Section 1202, it issues no guidance and few letter rulings. There are few cases, suggesting that there are few audits. Each Section is a prime candidate for repeal in a broad tax reform bill. The IRS is historically reluctant to allocate assets to complex provisions that might have a short life.[13]

◊ This creates an often frustrating situation in which the stakes are high, there many ambiguities but little guidance for taxpayers, the statute has problems but Congress is more likely to repeal the provision than to fix it, and the IRS might be reluctant to audit. Nevertheless, taxpayers and their tax preparers who do not follow the confusing but unambiguous parts of the statute might be subject to penalties.

2.2(b) The Section 1202 exclusion was enacted in 1993[14] because Congress believed "that targeted relief for investors who risk their funds in new ventures [and] small businesses … will encourage investments in these enterprises. This should encourage the flow of capital to small businesses, many of which have difficulty at-

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[12] If the taxpayers used the Section 1045 rollover one or more times, the taxpayer will need records his or her holding period for all of the corporations over all of the holding periods. If the shares were distributed to the taxpayer from a partnership or LLC, the taxpayer will need the records of the partnership or LLC. See Appendix A, *Documenting a Section 1202 Exclusion or a Section 1045 Rollover*.

[13] The 100% exclusion initially applied only for stock acquired in 2010. [WCS]

[14] Omnibus Budget Reconciliation Act of 1993, Pub. L. 103-66, § 13113(a) (1993).

tracting equity financing."[15] The exclusion was expanded to 100% of the gain with no AMT tax in 2010 based on the belief that "increasing the exclusion of gain for small business stock will encourage … new and additional investment in small businesses. Access to additional capital will help these small businesses expand and create jobs."[16]

2.2(c) "The provision generally permits a noncorporate taxpayer who holds qualified small business stock for more than 5 years to exclude [a portion of the] gain on the sale or exchange of the stock. The amount of gain eligible for the … exclusion is limited to the greater of (1) 10 times the taxpayer's basis in the stock or (2) $10 million gain from stock in that corporation."[17]

2.2(d) The exclusion applies to gain on the disposition of "qualified small business stock."[18]

2.2(e) To be "qualified small business stock," the corporation must be a "qualified small business" on the date the shares were issued.[19]

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[15] Fiscal Year 1994 Budget Reconciliation Recommendations of the Committee on Ways and Means as Submitted to the Committee on the Budget pursuant to H. Con. Res. 64, H.R. Rept. No 103-111, Publ. No. 103-66, at Title XIV.I.B.2. (May 16, 1993) (the "1993 Ways and Means Committee Report").

[16] House Ways and Means Committee, (H. Rept. No. 111-447, March 19, 2010) on H.R. 4849, Small Business and Infrastructure Jobs Tax Act of 2010, which was folded into the Creating Small Business Jobs Act of 2010 (Pub. L. 111-240, § 2011).

[17] *Id.*

[18] I.R.C. § 1202(a).

[19] I.R.C. § 1202(c)(1)(A), (d)(1).

◊ To be a "qualified small business," the business must be small, satisfying asset tests before and after the shares were issued.[20]

◊ The corporation must be a C corporation on the date that the shares were issued.[21]

◊ Also, the corporation must agree to submit to the IRS and to the shareholders such "reports" as the IRS may require to assure that Section 1202 applies.[22]

◊ Note that these tests apply when the shares are issued.

2.2(f) The shares also will not be "qualified small business stock" if the corporation's shares were redeemed soon before or after the issuance of the shares to which the exclusion might apply.[23] This rule exists "to prevent evasion of the requirement that the stock be newly issued."[24]

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[20] I.R.C. § 1202(d). See Section 2.3(h) below.

[21] I.R.C. § 1202(d). See Section 2.3(h) below.

[22] I.R.C. § 1202(d)(1)(C). There is no requirement to file this agreement with the IRS. See Section 2.8 below. *From the investor's perspective, it would be a good practice to cover this in the subscription agreement to buy the shares. From the selling shareholder's perspective, it would be a good idea to cover this in the stock purchase agreement and to require the corporation to attach a statement to this effect to its return for the year in which the stock sale occurs.*. The IRS can impose a $50 penalty for failing to provide each "report." I.R.C. § 6652(k). The penalty increases to $100 per "report" if the failure is "due to negligence or intentional disregard." But no penalty is imposed for a failure that is shown to be due to reasonable cause and not to willful neglect. See Treas. Reg. § 301.6652-1(f) (how to show reasonable cause).

[23] I.R.C. § 1202(c)(3). See Section 2.3(i) below.

[24] The 1993 Ways and Means Committee Report.

2.2(g) The shares will not be "qualified small business stock" unless, "during substantially all of the taxpayer's holding period," the corporation meets the *active business requirements* and is a C corporation.[25]

◊ Note that these tests are applied for each year that the shares are held by the taxpayer. A worksheet with a row for each requirement and a column for each year is useful. Then it's necessary to determine whether all of the requirements were satisfied for "substantially all" of the years.

◊ There is no certainty about what "substantially all" means – 80% or more is probably good. Less than 80% is iffy. Less than 2 out of 3 years is probably not "substantially all" of the years.

2.2(h) To meet the *active business requirement*, the corporation must be an "eligible corporation" and at least 80% of its assets (by value) must be "used in … the active conduct of one or more qualified trades or businesses."[26]

◊ To be an "eligible corporation," the corporation can't be a foreign corporation, a DISC, a REIT, or qualify for a possessions tax credit.[27]

◊ Section 1202 contains a list of trades or businesses that cannot be "qualified trades or businesses."[28]

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[25] I.R.C. § 1202(c)(2)(A).

[26] I.R.C. § 1202(e)(1).

[27] I.R.C. § 1202(e)(4).

[28] I.R.C. § 1202(e)(3). See Section 2.4 below.

- A special rule applies to software companies that receive royalties.[29] A business that receives royalties is not on the list of trades or businesses that can't be "qualified trades or businesses." So the special rule seems to provide a "safe harbor" for the "active conduct" requirement. The special rule should not be the only way that a software business can be an active business for this purpose.

◊ Some assets are assumed to be used in a "qualified trade or business." These are assets used in startup activities, research and experiments, and in-house research, even if the corporation has no gross income.[30]

◊ Look-through rules apply to treat activities of a subsidiary as the activities of a parent for the "active business" tests.[31]

- If the issuing corporation owns interests in disregarded entities that are engaged in "qualified trades or businesses," the corporation should be treated as engaged in the activities.[32]

- If the issuing corporation owns interests in entities that are classified as partnerships for income tax

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[29] I.R.C. § 1202(e)(8). See Section 2.4(e) below.

[30] I.R.C. § 1202(e)(2).

[31] I.R.C. § 1202(e)(5)(A), (C).

[32] Treas. Reg. § 1.7701-2(a) ("[I]f the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner."), (c)(1) ("[A] business entity that has a single owner and is not a corporation … is disregarded as an entity separate from its owner."), -3(b)(1) ("A domestic eligible entity is … disregarded as an entity separate from its owner if it has a single owner.")

purposes, the corporation should be treated as engaged in the activities in proportion to its interest in the partnership.[33]

◊ The corporation will fail the active business requirement if for more than an insubstantial part of the taxpayer's holding period portfolio stocks and securities (a) make up more than 10% of the corporation's assets (net of liabilities; in other words, it's balance sheet "Equity") are , and (b) are not held for use as working capital or to deploy in an active business within two years.[34]

◊ The corporation will also fail the active business requirement if for more than an insubstantial part of the taxpayer's holding period more than 10% of its assets are real estate not used in an active trade or business (but owning, dealing in or renting real estate is not an active business for this purpose).[35]

2.3 The details - To qualify for the exclusion:

2.3(a) The selling *shareholder* can't be a C corporation.[36]

2.3(b) The stock must be held for five years.[37]

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[33] I.R.C. § 702(b), (c); Treas. Reg. § 1.702-1(b), (c); *see* Rev. Rul. 71-455, 1971-2 CB 318. I did not find authority discussing these rules in the context of Section 1202.

[34] I.R.C. § 1202(e)(6).

[35] I.R.C. § 1202(e)(7).

[36] I.R.C. § 1202(a)(1).

[37] I.R.C. § 1202(a)(1).

2.3(c) The issuing corporation must be a domestic C corporation, but not a DISC, a regulated investment company, a REIT, a REMIC or a co-op.[38]

◊ Note that an S corporation election is effective as of the first day of the taxable year in which it becomes effective.[39] So if a corporation is incorporated in April and issues shares in April, and files a S corporation election in May, the election will be effective as of the incorporation date, unless the election was specifically stated to be effective as of the beginning of the next year.[40] In that situation, the shares were probably not issued by a C corporation for purposed of Section 1202.

◊ However, if the S corporation election was never effective (for example, if the shares were community property buy a spouse did not consent to the S corporation election), the corporation never became an S corporation and would satisfy the requirements for C corporation status.[41]

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[38] I.R.C. § 1202(e)(4).

[39] I.R.C. § 1362(c); Treas. Reg. § 1.1362-1(b). The rule in these regs that "the taxable year of a new corporation begins on the date that the corporation has shareholders, acquires assets, or begins doing business, whichever is the first to occur" is a taxpayer-friendly rule for making S corporation elections It is unlikely that it overrides the general rule that a corporation's first tax year begins on the date of its incorporation. Treas. Reg. § 1.443-1(a)(2).

[40] Treas. Reg. § 1.1362-6(a)(2)(ii)(A).

[41] Clemens v. Comm'r, 453 F.2d 869 (9th Cir. 1971); Forrester v. Comm'r, 55, 49 T.C. 499 (1968).

2.3(d) For the 100% exclusion for the regular federal income tax and the federal AMT, the shares must be issued by a C corporation to the taxpayer after September 27, 2010.[42]

2.3(e) For stock issued by a C corporation before that date but after August 10, 1993, a less wonderful version of the exclusion is available:[43]

- ◊ After August 10, 1993 and before February 18, 2009 – 50% of the gain is excluded from regular tax, and 7% of the regular tax exclusion is included in AMT.

- ◊ After December 21, 2000 and before February 18, 2009 – 60% of some or all of the gain is excluded from regular tax if the business is a "qualified business entity" doing business in an "empowerment zone," and 7% of the regular tax exclusion is included in AMT.[44]

- ◊ After February 17, 2009 and before September 28, 2010 – 75% of the gain is excluded from regular tax, and 7% of the regular tax exclusion is included in AMT.[45]

2.3(f) During substantially all of the taxpayer's holding period for the shares, the issuing corporation must be a C corporation and satisfy the "active business requirement."[46]

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[42] I.R.C. § 1202(a)(4).

[43] I.R.C. § 1202(a)(1), (2), (3). The portion of the gain that is not excluded from income under Section 1202 is taxed at a 28% rate, not the 20% rate. I.R.C. § 1(h)(4)(A)(ii), (h)(7). Of the amount of gain excluded, 7% is an item of tax preference for alternative minimum tax (AMT) purposes. I.R.C. § 57(a)(7). The Section 1045 rollover might be of interest for taxpayers who acquired their Section 1202 shares during this period. See Section 3 below.

[44] I.R.C. §§ 1202(a)(2), 1397C(b).

[45] I.R.C. § 1202(a)(3).

2.3(g) The taxpayer can transfer cash, other property or services for the stock.[47]

◊ The taxpayer may convert shares of another class (such as convertible preferred stock) for the shares, and the holding period "tacks" (that is, includes the holding period of the original class of shares).[48]

◊ Generally, the taxpayer cannot exchange the stock of another corporation for the stock of the qualified small business.[49]

- In some Section 351 or 368 tax-free transactions, the new stock will be treated as qualified small business stock to the extent that the old stock would have qualified if the transaction was not tax-free.[50]

◊ Sold Shares of the Issuing Corporation, the basis of which (in the hands of the taxpayer) is determined in whole or in part by reference to the basis in his hands of other stock in the Issuing Corporation which was "qualified small business stock" or which is received in a re-incorporation ("Type F") reorganization in exchange for "qualified small business stock" is treated as "qualified small business stock." For this purpose, a successor corporation in a

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(footnote continued from previous page)

46 I.R.C. § 1202(c)(2)(A).

47 I.R.C. § 1202(c)(1)(B).

48 I.R.C. § 1202(f).

49 I.R.C. § 1202(c)(1)(B)(i).

50 I.R.C. § 1202(h)(4).

Type F reorganization is treated as the same corporation as its predecessor.[51]

◊ Congress intended that the only gains eligible for the exclusion are those that accrue after the taxpayer's investment in the corporation.[52] If the taxpayer contributes property (not services) other than money or stock to the issuing corporation in exchange for the shares, *the gain excluded by Section 1202 might be less than the total gain realized on the disposition of the shares*. This is because the gain excluded by Section 1202 is the amount realized, less an artificially high tax basis.[53]

- The tax basis used to determine the amount of tax to which the capital gain rate applies is the basis of the property in the hands of the taxpayer when the taxpayer exchanged the property for shares of the issuing corporation, increased by any income that the taxpayer recognized on the exchange and decreased by any money or other assets received by the taxpayer in the exchange.[54] Generally, this is a carry-over basis.

- The basis of the taxpayer's issuing corporation shares for purposes of the Section 1202 exclusion is the fair market value of the property contributed

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[51] I.R.C. §§ 1202(h(3), 1244(d)(2).

[52] The 1993 Ways and Means Committee Report.

[53] I.R.C. § 1202(i). The portion of the gain that is not excluded because of this basis rule is not automatically subject to the 28% tax rate, as is the gain not excluded by the pre-2010 percentage exclusion. I.R.C. § 1(h)(7)(A). See footnote 43 above.

[54] I.R.C. §§ 1(h)(1)(D), 358(a)(1)(B), 1001, 1222.

(valued as of the date contributed), not the basis of that property in the hands of the taxpayer.[55]

- The same Section 1202 rule applies to property contributed to the issuing corporation after the initial stock issuance.

2.3(h) The assets of the issuing corporation must not exceed $50 million after the stock is issued to the taxpayer.[56]

◊ This amount is not indexed for inflation.

2.3(i) The issuing corporation must not redeem its shares from the taxpayer for two years before or after the qualified small business stock is issued.[57]

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[55] I.R.C. § 1202(i).

[56] I.R.C. § 1202(d). "To prove that [replacement co.]'s aggregate gross assets did not exceed that statutory ceiling, [taxpayer] relies solely on his highly general testimony, the entirety of which is as follows: 'Q: Have the gross assets of [replacement co.] ever exceeded $50 million? A: No.' Petitioner purchased shares of [replacement co.] stock on 36 separate dates between January 4, 2002, and July 27, 2004. Yet he made no attempt to introduce balance sheets or other financial statements showing the amount of cash and property held by the corporation before and immediately after each of those dates or at any time during the corporation's existence. ... Absent corroborating documentary evidence, we need not, and do not, conclude, solely on the basis of petitioner's self-serving testimony, that [replacement co.]'s aggregate gross assets did not exceed $50 million on the days he received its stock. ... [The taxpayer] has failed to satisfy his burden of proving that [replacement co.] constituted a qualified small business on the purchase dates." Holmes v. Comm'r, 104 T.C.M. 250 (2012) (considering stock purchased in 1997, then sold and the proceeds rolled over into replacement shares in 2000 to 2004, the years at issue in the case), *aff'd on other issues in an unpublished opinion* 2015-1 U.S.T.C. ¶ 50,202 (9th Cir. 2015) (affirming the Tax Court's findings that the taxpayer did not establish (a) that the shares were issued to him from the corporation and were not transferred to him from other shares, and (b) that at least 80% of the corporation's assets were used in the active conduct of a "qualified trade or business").. See footnotes 63 and 69 below.

[57] I.R.C. § 1202(c)(3)(A); Treas. Reg. § 1.1202-2(a)

◊ Redemptions of stock from others within one year before or after the stock issuance will break the exclusion, but only if the total shares redeemed in the two year period exceeds 5% of the outstanding shares at the beginning of the two years.[58]

◊ For purposes of Section 1202, some redemptions are ignored.[59] These include:

- Repurchases of shares that had been transferred in connections with services performed by the shareholder for the issuing corporation (employees and directors, certainly; the IRS reserved its position on shares issued to independent contractors[60]);

- Repurchases of shares from deceased shareholders or their heirs, estates or trusts within three years and nine months after the date of death;

- Repurchases incident to the disability or mental incompetency of the shareholder; or

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[58] I.R.C. § 1202(c)(3)(B); Treas. Reg. § 1.1202-2(b) (which ignores small transactions).

[59] Treas. Reg. § 1.1202-2(d).

[60] 61 Fed. Reg. 28821 at 2882 (June 6, 1996) "The IRS and Treasury are particularly interested in comments regarding the scope of the exception for redemptions incident to the termination of employment. The IRS and the Treasury are committed to extending the exception to independent contractors, but seek comments regarding how to determine when a termination of the independent contractors service has occurred." *Id.* "One commenter suggested that the determination of whether services of and independent contractor were terminated should be based on all the facts and circumstances, with termination conclusively presumed if no further services were performed for six months. The IRS and Treasury Department have not adopted this suggestion, but are continuing to study this issue and request additional comments." T.D. 8749, 1998-1 C.B. 533 (December 30, 1997), Supplementary Information, Summary of Comments and Modifications (final Section 1202 regs).

- Repurchases incident to a divorce.

◊ A transfer of shares from a shareholder to a person who provides services to the corporation is treated as a redemption of the shares under the Section 83 regs, but *not* for purposes of Section 1202.[61]

◊ Section 304 sales to related corporations are treated as redemptions for this purpose.[62]

2.3(j) The taxpayer must acquire the shares at its original issuance by the corporation (either directly from the corporation or through an underwriter), unless a specific exception to this rule applies.[63]

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[61] Treas. Reg. §§ 1.83-6(d)(1), 1.1202-2(c).

[62] I.R.C. § 1202(c)(3)(C).

[63] I.R.C. § 1202(c)(1)(B). "[The taxpayer] has proffered no evidence beyond his own uncorroborated testimony to establish that he acquired [replacement co.] stock at its original issue. 'Original issue' is defined as the 'first issue of securities of a particular type or series.' ... [The taxpayer] offered no documentary evidence, such as stock certificates or book entries from the corporation, indicating from whom he acquired the stock on each of the 36 stipulated purchase dates. He further failed to submit evidence showing that on each of those 36 purchase dates, he purchased any of the original issue of that stock type or series. We cannot (and do not) find that petitioner acquired [replacement co.] stock at its original issue; petitioner has failed to carry his burden of proof on that point." Holmes v. Comm'r, 104 T.C.M. 250 (2012) (considering stock purchased in 1997, then sold and the proceeds rolled over into replacement shares in 2000 to 2004, the years at issue in the case), *aff'd in an unpublished opinion* 2015-1 U.S.T.C. ¶ 50,202 (9th Cir. 2015) ("The Tax Court did not clearly err in finding [the taxpayer] had failed to establish that he acquired the shares of [replacement co.] at original issue. [The taxpayer]'s testimony on this point was contradictory, and at one point he said that he acquired the shares from company officers.").

◊ One exception: Qualified small business stock acquired by gift or inheritance can qualify for the exclusion.[64]

2.3(k) A shareholder of an S corporation or a "partner" in an entity classified as a partnership for income tax purposes can use the exclusion (i) if he held his interest in the pass-through entity when that entity acquired the small business stock and (ii) if he held his interest in the entity until it disposed of the small business stock.[65]

◊ The distributee of qualified small business stock from a partnership can use the exclusion if the distributee held his interest in the partnership when the partnership acquired the small business stock and if the distributee held his interest in partnership until the partnership distributed the small business stock to the distributee.[66]

◊ Note that if an S corporation distributed the qualified small business stock, the S corporation would recognize gain on the distribution, so the exclusion would apply then.[67]

2.4 The active business requirement: at least 80% of the assets of the issuing corporation must be used in the active conduct of one or more "qualified trades or businesses."[68]

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[64] I.R.C. § 1202(h)(1), (2).

[65] I.R.C. § 1202(g).

[66] I.R.C. § 1202(h)(3).

[67] I.R.C. § 311(b), 1371(a).

[68] I.R.C. § 1202(c)(2)(A), (e)(1)(A). See Section 2.2(a) above. "It is apparent that [the corporation issuing the replacement stock in an intended Section 1045 rollover]] was never an active business within the meaning of section 1202(e). We note that as of August 1,

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2.4(a) This test must be satisfied "during substantially all of the taxpayer's holding period" for the shares. Although the statute does not say so, and the IRS has not provided guidance on the issue, it would be reasonable to test this for each "trade or business" for each year during the holding period.

2.4(b) Note that the test measures assets (by value) and how they are used. Receipts are not relevant.

2.4(c) The taxpayer should identify and retain documents that evidence that the corporation satisfies this test for each year that it does so.[69]

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2004 (about 2 years after the initial deposit), [replacement co.] had 16 pieces of jewelry [and had made sis sales, three to related parties]. Although [the taxpayer] explained at trial that his goal was to develop the business and indicated that it took time for a jewelry business to become established, 2 years after the money was injected, [replacement co.] was still not using it." Owen v. Comm'r, 102 T.C.M. 1135 (2012) (considering a sale in 2002).

[69] "In support of his position, [the taxpayer] again relies on his own testimony, the entirety of which is as follows: 'Q: Does [replacement co.] have investment assets[?] A: No investment assets. All of the revenue is used in its business.' The record is again devoid of documentary evidence showing the amount of corporate assets owned during the years in which he held the stock and the amount of those assets used in its business of providing on demand physician practice management software. In fact, the only evidence in the record concerning [replacement co.]'s business is a stipulated paragraph describing its business as "providing on demand physician practice management software delivered over the Web", and [the taxpayer]'s above-cited testimony. We cannot, on the basis of uncorroborated testimony and a stipulation that does not rule out inactive business assets and income, reasonably conclude that [the taxpayer] met his burden of proving that, during substantially all of his holding period for [replacement co.] stock, the corporation used at least 80% of its assets in the active conduct of one or more qualified trades or businesses." Holmes v. Comm'r, 104 T.C.M. 250 (2012) (considering stock purchased in 1997, then sold and the proceeds rolled over into replacement shares in 2000 to 2004, the years at issue in the case), *aff'd in an unpublished opinion* 2015-1 U.S.T.C. ¶ 50,202 (9th Cir. 2015) ("Nor did the Tax Court clearly err in finding [the taxpayer]'s conclusory and uncorroborated testimony insufficient to establish that at least

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2.4(d) Certain start-up activities, R&D and in-house research is treated as the active conduct of a business, even if no gross income is generated.[70]

2.4(e) A safe harbor is provided to enable a software company to prove that its business satisfies the "active conduct" part of the test.[71]

◊ The safe harbor includes tests that assume that the software corporation's gross sales exceed its cost of goods sold in all years. It is unclear how or if these tests apply for years in which the corporation has negative "ordinary gross income."[72]

◊ The Service concluded that fees for on-site training, support services and updates as well as fees for licensing the software can be included in "royalties" for purposes of the Section 543(d)(3) test.[73] Fees for on-site installations and customization assistance were not included in "royalties" for this purpose.

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80% of [replacement co.] assets were used in the active conduct of qualified trades or businesses").

[70] I.R.C. § 1202(e)(2).

[71] I.R.C. § 1202(e)(8). See text at footnote 29 above.

[72] I.R.C. § 543(b)(1), (d)(3), (4); Treas. Reg. § 1.61-3(a). The reference in Section 1202 to Section 543(d) is an ineffective tool for determining if the corporation "actively conducted" a software business in the years in which ordinary gross income is negative. Should the safe harbor not apply for those years? Should $1 be substituted for the negative ordinary gross income amount so that the tests will work?

[73] PLR 90-05-028, November 6, 1989 (concerning the possible status of the company as a personal holding company, not whether the company's stock was qualified small business stock).

◊ One test requires business deductions for the software business to exceed 25% of "ordinary gross income," but backs out the compensation of major shareholders from the numerator.[74] This provision says that certain attribution rules do not apply for this test. However, none of the personal holding company attribution rules apply for purposes of these tests.[75]

◊ One test merely requires that the corporation is engaged in the active conduct of the trade or business of developing, manufacturing or producing computer software.[76] For years in which the corporation satisfies this test, it probably satisfies the "active business" requirement of Section 1202, whether or not the corporation satisfies the other "safe harbor" tests.

2.4(f) The active business requirement does not apply to "specialized small business investment companies."[77]

2.4(g) Some liquid or investment assets can be treated as used in a trade or business for purposes of the 80% test.

◊ They must be needed for working capital of a qualified trade or business,[78] or

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[74] I.R.C. § 543(d)(4)(A), (C).

[75] I.R.C. § 544(a); Rev. Rul. 70-551, 1970-2 C.B. 130; *see* PLR 81-41-004, December 18, 1978 (reaching a similar conclusion).

[76] I.R.C. § 543(d)(2)(A).

[77] I.R.C. § 1202(c)(2)(B).

[78] I.R.C. § 1202(e)(6)(A).

◊ They will be used within two years either to finance R&D in a qualified trade or business or to fund increased needs for working capital.[79]

◊ After the issuing corporation has existed for two years, these rules cannot be used to consider more than half of the corporation's assets as used in a qualified trade or business.[80]

2.5 A "qualified trade or business" is any trade or business other than:[81]

2.5(a) Any trade or business involving the performance of services in the fields of:

◊ Accounting,

◊ Architecture,

◊ Actuarial science,

◊ Athletics,

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[79] I.R.C. § 1202(e)(6)(B).

[80] I.R.C. § 1202(e)(6) (flush language). "We recognize that section 1202(e)(6) apparently contemplates that even after 2 years up to 50 percent of a corporation's assets might in some circumstances be held as part of the reasonably required working capital needs of the business. But we leave for another day what amount of cash on hand can be considered actively used in a trade or business … that has been in existence for less than 2 years. We hold that under the surrounding facts here the fact that 92 percent of [the corporation's] assets were held in cash causes it to fail the active business requirement." Owen v. Comm'r, 102 T.C.M. 1135 (2012) (considering a sale in 2002). The Court noted that "The balance of the assets were held in the form of wholesale jewelry consisting of precious metals and precious stones, a form of liquidity favored by some over currency."

[81] I.R.C. § 1202(e)(3).

- ◊ Brokerage services,
- ◊ Consulting,[82]
- ◊ Engineering,
- ◊ Financial services,
- ◊ Health,
- ◊ Law,
- ◊ Performing arts, or
- ◊ Any trade or business where the principal asset of such trade or business is the reputation or skill of one or more of its employees;[83]

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[82] I.R.C. § 448(d)(2) contains a similar list of businesses that, if they are large C corporations, are allowed to use the cash method of accounting. "Consulting" is defined in the regs under this section as providing "advice and counsel" when the deliverable is a report or study, but not a sale or brokerage service. Treas. Reg. § 1.448-1T(e)(iv). The Service concluded that providing "educational training courses and education materials to computer users" was not "consulting for this purpose. PLR 89-13-012 (an undated private letter ruling responding to a 1988 request).

[83] "Although [the IRS] argues that [an insurance agency with 150 employees and 350 independent sales agents] is not qualified because one of the principal assets is the skill of [one of the principal shareholders, whose exclusion was considered by the Tax Court], the Court disagrees. While we have no doubt that the success of the [the agency] is properly attributable to [the two shareholder-employees], the principal asset of the companies was the training and organizational structure; after all, it was the independent contractors, including [the two shareholder-employees] in their commission sales hats, who sold the policies that earned the premiums, not [the principal shareholder whose case was before the Court] in his personal capacity." Owen v. Comm'r, 102 T.C.M. 1135 (2012) (considering a sale in 2002).

2.5(b) Any banking, insurance, financing, leasing, investing, or similar business,

2.5(c) Any farming business (including the business of raising or harvesting trees),

2.5(d) Any business involving the production or extraction of products of a character with respect to which a depletion deduction is allowable, and

2.5(e) Any business of operating a hotel, motel, restaurant, or similar business.

2.6 If the taxpayer contributes to the issuing corporation more than $1 million in cash or assets with a tax basis of more then $1 million, or a combination of the two totaling more than $1 million, the $10 million limit on gain is increased to ten times the basis of the contributed assets.[84]

2.7 Note the many ways to fail to qualify for the exclusion. Often, the Section 1202 exclusion is best used as a planning tool when something else prevents the business from using an LLC or an S corporation.

2.7(a) When an investor is counting on the Section 1202 exclusion to make the exit from the investment tax-free (or subject to one level of tax in an asset sale), it is important to conduct a review of the Section 1202 requirements each year.

2.7(b) Many requirements must be met in the first year, a few more over the first two years. In the last year, the corporation must be a C corporation.

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[84] I.R.C. § 1202(b)(1).

2.7(c) But other requirements must be satisfied for "substantially all years" in which the taxpayer held the shares. For those requirements, failing to meet the requirements for up to 20% of the years in the holding period might be OK. It is important to realize that "the train has left the tracks" before too many years go by and it becomes impossible to correct the problem.

2.8 Reporting the Section 1202 Exclusion

2.8(a) Report the regular tax exclusion on IRS Form 8949, Part II and (if required) the AMT tax preference on IRS Form 6521.

2.8(b) See the Instructions to IRS Schedule D (Form 1040) at "Exclusion of Gain on Qualified Small Business (QSB) Stock."[85]

2.8(c) See the Instructions to IRS Form 8949 at "You sold or exchanged qualified small business stock and can exclude part of the gain."

2.8(d) See IRS Publication 550, Investment Income and Expenses (Including Capital Gains and Losses) (2016), at page 67.

2.8(e) Note that it is important to report the gain and then back out the exclusion, to minimize the risk that substantial understatement penalties would be asserted for failing to disclose the gain -- if the exclusion is disallowed on audit..[86]

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[85] For a list other possible gain exclusions, see the Instructions to Schedule D to IRS Form 1040 for 2016 at page D-9.

[86] I.R.C. § 6662(d)(2)(B)(ii)(I); Treas. Reg. § 1.6662-4(e). "[The taxpayer] failed to report on each of the subject tax returns substantial amounts of gain from [original co.] stock sales. As a result he underreported his income for each year in issue. [The IRS] has shown by clear and convincing evidence that [the taxpayer] underpaid his tax for each year in issue. [The taxpayer] stipulated that he received proceeds in each year in issue from the sale of [original co.] stock and that he failed to include them in his income. He disputes the taxability of the re-

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2.8(f) In view of the complexity of Section 1202, the taxpayer should consider obtaining from a tax professional advice that will minimize the risk of a negligence penalty if the IRS challenges the exclusion and prevails. This will generally be a written analysis listing the requirements of Section 1202, the applicable facts and supporting documents, and reaching conclusions about whether the requirements are satisfied.[87]

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sulting gain, arguing his entitlement to defer its recognition pursuant to section 1045. [W]e find that he is not so entitled We find that respondent has shown by clear and convincing evidence that petitioner underreported his gross income and, consequently, underpaid his tax, for each year in issue... [The IRS] burden of production regarding the existence of substantial understatements of income tax for the years in issue." Holmes v. Comm'r, 104 T.C.M. 250 (2012) (considering stock purchased in 1997, then sold and the proceeds rolled over into replacement shares in 2000 to 2004, the years at issue in the case), *aff'd on other issues in an unpublished opinion* 2015-1 U.S.T.C. ¶ 50,202 (9th Cir. 2015). See footnotes 63 and 69 above.

[87] Compare the situation in the *Holmes* case. "In late 2000, [the taxpayer] spoke with [a co-founder of original co.] 'about selling the [original co.] stock and putting it [the proceeds] into [replacement co.]'. [The co-founder] told him about an article he had read concerning a tax provision that permits taxpayers to roll over gain from a startup company 'into another start-up company and then defer that tax until the profit from the second investment.' He said that petitioner 'should look into it.' [The co-founder].is neither a tax professional nor a financial adviser and did not provide to [the taxpayer] a written financial opinion. [The taxpayer] did not seek advice from other individuals as to the provision's procedures or requirements, and there is no evidence that he even read the provision.... A taxpayer may avoid the [substantial understatement and negligence penalties] by showing that he had reasonable cause for a portion of the [tax] underpayment and that he acted in good faith with respect to that portion. Reasonable cause requires that the taxpayer exercise 'ordinary business care and prudence' as to the disputed item. ... Generally, the most important factor is the extent of the taxpayer's effort to assess his proper tax liability. A taxpayer may demonstrate reasonable cause through good faith reliance on the advice of an independent professional, such as a tax adviser, lawyer, or accountant, as to the item's tax treatment. To prevail, the taxpayer must show that he: (1) selected a competent adviser with sufficient expertise to justify reliance, (2) supplied the adviser with necessary and accurate information, and (3) actually relied in good faith on the adviser's judgment. The professional's advice must be based on all pertinent facts and circumstances." Holmes v. Comm'r, 104 T.C.M. 250 (2012) (citations omitted) (considering stock

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3. SECTION 1045 EXCLUSION AND ROLLOVER

3.1 If the stock is "qualified small business stock" for purposes of Section 1202, the seller can escape federal income tax on its sale by rolling the proceeds over into "qualified small business stock" of another corporation.[88]

3.1(a) The exclusion is not available to *sellers* that are C corporations.[89]

3.1(b) This will rarely be attractive for sales of "qualified small business stock" held for five years and acquired after September 27, 2010 (to which the 100% gain exclusion and no AMT preference apply).[90]

3.1(c) However, it is very attractive for sales of qualified small business shares acquired earlier, the gain from which is subject to

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purchased in 1997, then sold and the proceeds rolled over into replacement shares in 2000 to 2004, the years at issue in the case), *aff'd on other issues in an unpublished opinion* 2015-1 U.S.T.C. ¶ 50,202 (9th Cir. 2015). See footnotes 63 and 69 above.

[88] I.R.C. § 1045. There is currently no corresponding California provision. Cal. Rev. & Tax. Code § 18038.4. So Section 1045 applies for federal income tax purposes only. Section 18038.5 of the Revenue and Taxation Code was a corresponding provision that expired on December 31, 2015. Cal. Stat. 2013, chapter 546, Section 1.

[89] I.R.C. § 1045(a). If the seller is classified as a partnership for tax purposes, the partners who are not C corporations may use the exclusion, as long as they held the partnership interest when the partnership bought the original shares and until the partnership disposed of the shares. Treas. Reg. § 1.1045-1(a), (g)(3). If the partnership interest is transferred by gift or inheritance, the done or heir is treated as holding the partnership interest for the period that the donor/decedent held the interest. Treas. Reg. § 1.1045-1(g)(3)(ii). Look-though rules apply for tiered partnerships. Treas. Reg. § 1.1045-1(g)(iii), (iv).

[90] See Section 2.3(d) above.

the partial exclusion and some of which is an AMT preference item.[91]

3.1(d) It will also be attractive for the sale of qualified small business stock held for more than six months, but less than five years, because *six months is the minimum holding period for Section 1045*.[92]

3.1(e) It will also be attractive for the sale of stock in a C corporation that ceased to meet the "active conduct of a trade or business" requirement after the taxpayer held the shares for at least six months.[93]

3.1(f) Section 1045 will also be attractive if the taxpayer transferred to the original Issuing Corporation assets that had a value substantially higher that their tax basis.[94]

3.2 This section was enacted in 1997 to allow "an individual to roll over tax-free gain from the sale or exchange of qualified small business stock held more than 6 months where the taxpayer uses the proceeds to purchase other qualified small business stock within 60 days of the sale. For purposes of the rollover provision, the replacement stock must meet the active business requirement for the 6-month period following the purchase. Generally, the holding period of the stock pur-

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[91] See Section 2.3(e) above.

[92] I.R.C. § 1045(a). See Section 2.3(b) above for the holding period under Section 1202.

[93] I.R.C. § 1045(b)(4)(B). Section 1045 appears to be available if the issuing corporation was an S corporation for a period commencing sometime after the first 6 months of the taxpayer's holding period and ending sometime before the shares were sold. *Id.*

[94] Section 1202 does not apply to that pre-contribution gain. I.R.C. § 1202(i). See text at footnote 53 above. Does the Section 1045 exclusion apply to that gain? Section 1045 seems to say "Yes." I.R.C. § 1045(a). Does the reference later in Section 1045 to the basis rule in Section 1202 mean "No"? I.R.C. § 1045(b)(5). There is no answer.

chased will include the holding period of the stock sold, except for purposes of determining whether the 6-month holding period is met. The provision applies to sales after [August 5, 1997]."[95]

3.2(a) "The Congress hoped that by providing deferral of gain recognition for funds reinvested in qualifying small businesses that investors will make more capital available to the new, small businesses that are important to the long term growth of the economy."[96]

3.3 The reinvestment must occur within 60 days after the sale.[97]

3.3(a) The reinvestment may be made through a partnership that buys the replacement stock.[98]

3.3(b) The taxpayer (and return preparer) must be prepared to prove that the reinvestment was made, the amount reinvested, and the date of the reinvestment.[99]

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[95] Conference Report, H.R. 105-220 on the Taxpayer Relief Act of 1997 at 383-85 (July 30, 1997).

[96] Staff of the Joint Tax Committee of the U.S. House of Representatives, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997, at p. 58 (December 17, 1997).

[97] I.R.C. § 1045(a)(1). "We agree the [taxpayer couple] met the 60-day requirement of section 1045(a)(1) when they signed the stock purchase agreement [for the original qualified small business stock] on June 17, 2002, and then deposited $1,916,827.07 into [the bank account of the corporation that issued the replacement stock] on August 14, 2002." Owen v. Comm'r, 102 T.C.M. 1135 (2012) (considering a sale in 2002).

[98] Treas. Reg. § 1.1045-1(a).

[99] "[C]ontrary to [the taxpayer]'s position that section 1045 shields him entirely from each year's deficiency in tax, he concedes that he failed to meet the section 1045(a)(1) 60-day requirement for some of his [36 replacement co.] stock purchases. At trial, he testified that he did not purchase [replacement co.] stock within 60 days of the 2000 [original co. stock] sale. In addition, on brief, he concedes his failure to reinvest all of his [original co. stock]

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3.4 An election must be made on the tax return for the year of the sale.[100]

3.5 Gain is recognized to the extent that the amount reinvested is less than the sale proceeds.[101]

3.6 The exclusion does not apply to gain treated as ordinary income.[102]

3.7 The purchase price basis in the new shares is reduced by the unrecognized gain in the shares sold.[103]

3.8 The holding period of the new shares includes the holding period of the shares sold.[104]

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2001-04 sale proceeds in [replacement co.] stock, stating only that he reinvested 'a substantial portion of the proceeds from the sale of [original co.] stock … in [replacement co/.] within the 60-day period following such sale'." Holmes v. Comm'r, 104 T.C.M. 250 (2012) (considering stock purchased in 1997, then sold and the proceeds rolled over into replacement shares in 2000 to 2004, the years at issue in the case), *aff'd on other issues in an unpublished opinion* 2015-1 U.S.T.C. ¶ 50,202 (9th Cir. 2015). See footnote 63 above.

[100] I.R.C. § 1045(a).

[101] *Id*.

[102] I.R.C. § 1045(a). Neither the legislative history nor the one regulation and one revenue procedure issued by the IRS provide examples of stock sales that would be treated as ordinary income. Presumably, this limited to the Corn Products doctrine (that stock held as inventory is not treated as a capital asset) and Section 336(e) and 338 transactions in which the sale of shares is treated as a sale of assets.

[103] I.R.C. § 1045(b)(3).

[104] I.R.C. § 1045(b)(4)(A).

3.9 Reporting the Section 1045 Exclusion

3.9(a) The Section 1045 election is made on the return for the year in which the gain is realized.[105]

3.9(b) If the taxpayer has more than one sale of qualified small business stock during the year, the taxpayer can chose the sales to which the Section 1045 election will apply.[106]

3.9(c) The election, once made,. cannot be revoked by filing an amended return unless the taxpayer first obtains a private letter ruling in which the IRS permits the revocation.[107]

3.10 Rules for Section 1045 rollovers involving partnerships have been published as regulations. These include extensive examples showing the mechanics Section 1045.[108]

3.11 Note that a taxpayer (and the return preparer) using Section 1045 must be prepared to prove that both the original shares and the replacement shares satisfied all of the requirements of "qualified small business stock" at the required times and for the required periods.[109] It's a bit

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105 Rev. Proc. 98-48, 1998-2 C.B. 367, Section 3.

106 Rev. Proc. 98-48, 1998-2 C.B. 367, Section 3.03.

107 Treas. Reg. § 1.1045-1(a); Rev. Proc. 98-48, 1998-2 C.B. 367, Section 3.04.

108 Treas. Reg. § 1.1045-1.

109 "Under section 1045, both the stock sold and the stock purchased by the taxpayer during the 60-day period beginning on the date of the sale must be qualified small business stock. Sec. 1045(a). Because [the taxpayer in this case] has failed to prove that any of the [replacement co.] stock he purchased was qualified small business stock, we need not consider the question of whether the [original co.] stock sold in each year in issue was qualified small business stock. We also need not address petitioner's argument that he reinvested the proceeds from those sales within a 60-day period, as prescribed by section 1045(a)(1)." Holmes v. Comm'r, 104 T.C.M. 250 (2012) (considering stock purchased in 1997, then sold and the proceeds rolled over into replacement shares in 2000 to 2004, the years at issue in the case), *aff'd*

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like taking a position that a 40(k) plan is a qualified plan – but without the assurance provided by a determination letter on the adoption of the plan and the involvement of a professional plan administrator for each year.

4. SECTION 1244 STOCK

4.1 Tax benefit

4.1(a) Section 1244 allows an individual shareholder to treat loss on the sale of certain stock as ordinary loss, not capital loss.[110]

4.1(b) The maximum amount of capital loss that can be changed to capital gain each year is $50,000 per taxpayer - $100,000 for a joint return. The limit applies to the year in which the loss is realized, not the year in which the shares were issued. The limit applies to taxpayers, so an individual with losses of $60,000 from each of three corporations in the same year would be limited to one $50,000 benefit, not three.

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on other issues in an unpublished opinion 2015-1 U.S.T.C. ¶ 50,202 (9th Cir. 2015). See footnotes 63 and 69 above.

[110] Individual partners of partnerships that hold Section 1244 stock may also use the benefit. Treas. Reg. § 1.1244(a)-1(b)(2). "Individual" does not include a an estate or a trust. *Id*. Will shares in a grantor trust (such as a typical "living trust" qualify? It's unresolved after all these years. Maybe due to lack of audit activity. Shareholders of an S corporation that owns stock in another corporation cannot use Section 1244 for the stock in the other corporation. Rath v. Comm'r, 101 T.C. 196 (1993). Note that the requirements for Sections 1202 and 1244 are similar, but not the same. Nor is a "small business corporation" the same for these purposes as for Section 1361 (eligibility to be an S corporation). This could be a poster child for unnecessary complexity in the Internal Revenue Code. California follows Internal Revenue Code Section 1244, even though California taxes ordinary income the same as capital gain. Cal. Rev. & Tax. Code § 18151.

4.1(c) Section 1244 rarely useful for those S corporation shareholders who are active in the business – who can use the pass-through losses to offset ordinary income from other sources.

◊ Those losses will drive down the basis in the shares.

◊ When the active shareholder finally abandons the business or sells the shares, there will be little, if any, basis left in the shares.

◊ A low basis in the shares means not much capital loss, if any, will be realized.

◊ Section 1244 is helpful only when – and to the extent – capital loss is realized.

4.2 The rules

4.2(a) Like Section 1202, there are several limitations on Section 1244.[111]

4.2(b) The stock must be issued for money or property – not for services, stock or other securities.[112] The increase in stock basis from capital contributions or expenses to protect an existing investment does not benefit from the Section 1244 recharacterization.[113]

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[111] *See generally* A. Polito, SMALL BUSINESS CORPORATION STOCK: SPECIAL TAX INCENTIVES, Tax Mgmt. Port. (BNA) No. 760-3rd (2016).

[112] I.R.C. § 1244(c)(1)(B). Stock issued after 1984 may be common or preferred stock. The stock must not be acquired by purchase, gift, inheritance or distribution from another entity. Treas. Reg. § 1.1244(a)-1(b)(2).

[113] Treas. Reg. § 1.1244(c)-1(b); Smyers v. Comm'r, 57 T.C. 189 (1971).

4.2(c) The corporation must be a domestic corporation.[114]

4.2(d) Most of the corporation's gross receipts must be from an active business, not from "royalties, rents, dividends, interests, annuities, and sales or exchanges of stocks or securities."[115]

4.2(e) The capitalization of the corporation must not exceed $1MM, using the basis of contributed property and reducing that basis by debt to which the property is subject.[116]

4.2(f) If the taxpayer cannot use the ordinary loss in the year in which the loss is realized, the taxpayer can carry it forward as an NOL.[117]

4.2(g) The issuing corporation should maintain records to support the qualification of the shares as Section 1244 stock, but it is not required to do so as a condition of the benefit.[118]

4.2(h) The taxpayer must retain records that support taking the tax benefit.[119] However, since 1995 it has not been necessary to file with the tax return a statement supporting the position.[120]

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[114] I.R.C. § 1244(c)(1).

[115] I.R.C. § 1244(c)(1)(C). There does to appear to be an exception for "active" royalties earned by a software company, as there is for Section 1202 and for the personal holding company rules.

[116] I.R.C. § 1244(c)(3)(A). A redemption of shares does not reduce the amount contributed for this purpose. Treas. Reg. § 1.1244(c)-2(b)(1).

[117] I.R.C. § 1244(d)(3).

[118] Treas. Reg. § 1.1244(e)-1(a)(2).

[119] Treas. Reg. § 1.1244(e)-1(b).

[120] Notice 94-89, 1994-2 C.B. 560; T.D. 8594, 1995-1 CB 146.

4.3 Section 1244 plan

4.3(a) A Section 1244 plan has not been required – or helpful – since 1978. Even though some corporate sets still arrive with these plans.

4.3(b) However, if stock was issued on or before November 6, 1978, and not pursuant to a Section 1244 plan, it cannot qualify as Section 1244 stock.[121]

4.4 The bottom line:

4.4(a) Because of the relatively small amount of the tax benefit afforded by Section 1244, it will rarely make sense to structure investments with it in mind.

4.4(b) The business considerations should dictate the transaction, not the possible use of Section 1244 if the new venture fails.

4.4(c) It is good to be aware of Section 1244 when filing returns that include capital loss on closely-held stock, and to see if it applies.

5. S CORP STOCK TRANSFER ISSUES

5.1 The corporate and tax law rules collide when S corporations directors want to pay dividends to people who no longer hold shares.

5.2 **A Parable**. Let's say Dave owns 25% of the outstanding shares of Widget Corporation, which was an S corporation for all of 2016. Dave transferred all of his shares to Jennifer on January 1, 2017. On March 1, 2017 Widget Corporation pays a dividend to the shareholders of record on March 1, 2017. The dividend is intended to allow the 2016 shareholders to pay their tax on Widget Corporation's 2016 in-

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[121] Treas. Reg. § 1.1244(c)-1(f)(1)(i).

come. Jennifer is the shareholder of record on March 1, so Jennifer receives the dividend on her shares.

5.2(a) Dave says to Jennifer "Excuse me, but that's my dividend you're holding. It is supposed to pay my tax liability for holding those shares in 2016. You, Jennifer, don't need it because you did not hold any Widget Corporation shares in 2016. In fact, the IRS regulations allow me to receive this dividend without creating a one-class-of-stock problem."[122]

5.2(b) Jennifer says "Sorry, Dave. I keep the dividend. Although tax law allows it, corporate law does not allow a California corporation to declare a dividend to shareholders of record as of a date earlier than the date of the directors action. We did not cover this in our Stock Purchase Agreement, so I have no obligation to give my dividend to you."[123]

5.2(c) Dave rends his garment -- and goes looking for the accountant and attorney who advised him in the stock sale.[124]

5.2(d) Moral: To assure that the people who pay taxes on the S corporation's income get the benefit of that income, they need either (i) to include in the price of the shares the value of the inherent right to receive tax-free distributions, or (ii) to cause the S cor-

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[122] Treas. Reg. § 1.1361-1(*l*)(2)(iv).

[123] The identity of the person entitled to a dividend from a California corp can be changed "by agreement" (Cal. Corp. Code § 701(d)), but the shareholders and the S corporation should be very wary of doing so, because the agreement might be the create a second class of stock, terminating the S corporation status.

[124] Dave's accountant tells him that he reduced his gain on the sale of his shares by the tax basis in the shares that he would have lost if he received the distribution. Dave says "Great, I saved 33 cents on the dollar, but lost 67 cents on the dollar to Jennifer."

poration to distribute immediately before any stock transaction all of the cash that the corporation can distribute tax–free.[125]

5.3 Note that individual shareholders benefit from undistributed S corporation profits because the profits increase their tax basis in their shares. Distributions reduce that basis.[126] For S corporations with undistributed C corporation profits, the "accumulated adjustments account" tracks the undistributed S corporation profits at the corporate level to determine when all of the S corporation profits have been distributed and taxable C corporation dividends begin.[127] A shareholder who disposes of his S corporation shares ceases to have any interest in the corporate-level "AA" account, but still benefits by his elevated tax basis in his shares. But as David found in the parable above, a dollar of basis is not the same as a dollar in cash.

[End of outline.]

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[125] If the corporation needs the cash, the shareholders can loan it back to the corporation.

[126] I.R.C. § 1367(a).

[127] I.R.C. § 1368.

Appendix A

Documenting a Section 1202 Exclusion or a Section 1045 Rollover

"The Commissioner's determination of a deficiency is presumed correct, and the taxpayer bears the burden of proving that the determination is improper. … However, pursuant to section 7491(a)(1), *the burden of proof on a factual issue that affects the taxpayer's tax liability may be shifted to the Commissioner where the 'taxpayer introduces credible evidence with respect to … such issue*.' The burden will shift only if the taxpayer has, [among other things], complied with substantiation requirements pursuant to the Code and 'maintained all records required under this title and *has cooperated with reasonable requests by the Secretary for witnesses, information, documents, meetings, and interviews'*. Sec. 7491(a)(2)."[128]

"[To avoid return preparer penalties under Section 6694,] the tax return preparer generally may rely in good faith without verification upon information furnished by the taxpayer. … The tax return preparer is not required to audit, examine or review books and records, business operations, documents, or other evidence to verify independently information provided by the taxpayer, advisor, other tax return preparer, or other party. The tax return preparer, however, may not ignore the implications of information furnished to the tax return preparer or actually known by the tax return preparer. The tax return preparer must make reasonable inquiries if the information as furnished appears to be incorrect or incomplete. Additionally, some provisions of the Code or regulations require that specific facts and circumstances exist (for example, that the taxpayer maintain specific documents) before a deduction or credit may be claimed. *The tax return preparer must make appropriate inquiries to determine the existence of facts and circumstances required by a Code section or regulation as a condition of the claiming of a deduction or credit*."[129]

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[128] Owen v. Comm'r, 102 T.C.M. 1135 (2012) (a Section 1045 case considering a sale and rollover in 2002; holding that the corporation into which the sale proceeds were reinvested was not a "qualified trade or business" and imposing accuracy-related penalties) (emphasis added).

[129] Treas. Reg. § 1.6694-1(e)(1) (emphasis added).

A.1. **The Issuance of the Qualified Small Business Stock**

A.1.1. Obtain a copy of the stock certificate for the shares that were sold, generating the gain to which Section 1202 and/0r Section 1045 will apply (the "**Sold Shares**"). Reason: To document the ownership of the shares, the identity of the issuing corporation and the date on which the shares were issued (the "**Issue Date**")

A.1.2. Obtain a copy of any subscription agreement or other agreement to issue the Sold Shares. Reason: To document what the taxpayer transferred to the corporation in exchange for the Sold Shares.

A.1.2.1. Identify any provision in the agreement requiring the corporation to provide tax information to the taxpayer or to the IRS.[130]

A.1.2.2. If the taxpayer transferred assets other than cash or services to the corporation for the Sold Shares, determine the value of those assets at the time they were contributed to the Issuing Corporation.[131] Obtain declarations and reps to document this value.

A.1.3. If possible, obtain a copy of the resolutions of the board of directors of the corporation that issued the Sold Shares (the "**Issuing Corporation**"). Reason: To document what the taxpayer transferred to the corporation in exchange for the Sold Shares and its value at that time.

A.1.4. If possible, obtain a copy of any securities law filings made for the issuance of the Sold Shares. This might include a Notice to the California Commissioner of Corporations under Section 25102(f) or (h). Rea-

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[130] See text at footnote 22 above.

[131] I.R.C. § 1202(i). See text at footnote 53 above.

son: To document the Issue Date and the total value of the consideration for the Sold Shares.

A.2. **The Old Shares**

A.2.1. If the Sold Shares were obtained by the taxpayer by converting other shares of the Issuing Corporation, treat the date on which the other shares were issued to the taxpayer as the "Issue Date" for purposes of this Appendix.[132] The old shares must be "qualified small business stock" on the date of the conversion, or gain on the disposition of the Sold Shares will not qualify under Section 1202. Obtain as much of the documentation described in Section A.1 above as possible for the old shares.

A.2.2. If the Sold Shares were obtained by the taxpayer by gift, inheritance or from a partnership, treat the date on which the Sold Shares were issued to the original shareholder as the "Issue Date" for purposes of this Appendix.[133] Obtain as much of the documentation described in Section A.1 above as possible. Document the transfer of the Sold Shares to the taxpayer (the stock assignments, at a minimum; possibly also the gift tax return, if any, filed to reflect the gift).

A.2.3. If the taxpayer acquired the Sold Shares in a tax-free exchange under Section 351 or 368 (including a Type F reorganization), would the old shares have been "qualified small business stock" if they had been sold on the date of the exchange? If so, do the other requirements of Section 1202(h)(4) apply? If so, obtain documentation, declarations and reps to evidence those conclusions.

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[132] I.R.C. § 1202(f).

[133] I.R.C. § 1202(h)(1), (2), (3).

A.3. **The Sale of the Qualified Small Business Stock**

A.3.1. Obtain a copy of the sale agreement for the Sold Shares. Reason: To document the sale date and the amount paid for the Sold Shares.

A.3.2. Obtain a copy of the stock assignment separate from certificate by which the taxpayer transferred the Sold Shares. Reason: To document the actual transfer of the Sold Shares and the transfer date.

A.4. Liquidation of the Issuing Corporation (Rather than a Sale of Shares)

A.4.1. Obtain a copy of the IRS Form 966 and attachments filed by the Issuing Corporation when it adopted its plan of liquidation. Reason: To document that the distributions after that date were liquidating distributions that were deemed sales or exchanges of the Sold Shares.[134]

A.5. Declarations and Representations

A declaration is written statement made under penalty of perjury that the signor would, if called to testify in court, truthfully make the statements listed.[135] It can be used as evidence even if the signor has died or is otherwise not available.[136] A declaration by a corporation would actually be a declaration by an officer who has personal knowledge of the facts, or at least no knowledge that the statements are not true.

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[134] See footnote 8 above. Note that it does not matter in a liquidation whether the Issuing Corporation collects the stock certificates for the Sold Shares from the shareholders. It is a best practice to do so, however, to avoid questions in the future about the possible value of those certificates.

[135] Cal. Civ. Proc. § 2015.5. In contrast, an affidavit is made under oath and notarized.

[136] Cal. Civ. Proc. § 98. See 1 Witkin, CAL. EVIDENCE, Hearsay § 18 Supp. (5th ed. 2012).

A representation (or "rep") would made by the Issuing Corporation in the sale document, just like the representations that the taxpayer makes that he owns the shares and has the authority to sell them.[137] If the sale document is already signed, it will not be possible to get representations and an effort should be made to get a declaration from a corporate officer.

If the taxpayer was an executive officer of the Issuing Corporation for all or most years since the Issue Date, a declaration from the taxpayer is probably sufficient to support the tax return preparer's position on the taxpayer's return – unless the preparer has reason to doubt the declaration. However, even if the taxpayer was a corporate officer, the statements will have more credibility in a tax audit if they are also made in reps or a declaration from another corporate officer.

A.6. Redemptions

A.6.1. Obtain a declaration from the taxpayer and a representation or declaration from the Issuing Corporation that none of the taxpayer's shares of the Issuing Corporation or any related corporation were redeemed in the two years before or the two years after the Issue Date.[138]

A.6.2. Obtain a representation or declaration from the Issuing Corporation that none of the shares of the Issuing Corporation were redeemed or sold to a related corporation during the year before or the year after the Issue Date.[139]

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[137] If a party makes a material representation is not true, the other party may be entitled to legal remedies, including rescinding the contract. 1 Witkin, SUMMARY OF CALIFORNIA LAW, Contracts § 307 Supp. (10th ed. 2005)

[138] See Section 2.3(i) above. Note that a redemption after the five-year holding period under Section 1202 will not prevent Section 1202 from applying. However, Section 1202 might not apply to a redemption that is not treated under IRC Section 302 as a sale exchange. If in doubt, don't structure the transaction as a redemption.

[139] See Section 2.3(i) above.

A.7. **Qualified Small Business**

A.7.1. If the Issuing Corporation existed for a short time before the Issue Date, obtain all of the tax returns of the Issuing Corporation.

A.7.2. If the Issuing Corporation existed for many years before the Issue Date, (a) obtain representations of the Issuing Corporation that it satisfied the "qualified small business" test for all years prior to the Issue Date,[140] and (b) obtain the tax returns of the Issuing Corporation for all years (the "Holding Years") including and after the Issue Date.

A.8. **The Active Business Requirement**

A.8.1. Is the Issuing Corporation a "specialized small business investment company"?[141] If so, document that and skip the rest of this Section A.8.

A.8.2. Obtain a declaration from the taxpayer and a representation or declaration from the Issuing Corporation that the corporation met the "eligible corporation" tests.[142] Examine the tax returns of the Issuing Corporation to confirm this.

A.8.3. Obtain a declaration from the taxpayer and a representation or declaration from the Issuing Corporation either that the Issuing Corporation was not engaged in any of the prohibited trades or businesses since the Issue Date, or that less than 20% of the Issuing Corporation's assets (by value) were used in prohibited trades or businesses at all times since the Issue Date (or at least in 80% of the Holding Years).[143]

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140 I.R.C. § 1202(d).

141 I.R.C. § 1202(c)(2)(B).

142 I.R.C. § 1202(e)(4). See Sections 2.2(h) and 2.3(c) above

143 See Section 2.5 above for a list of the prohibited trades or businesses.

A.8.4. If during some of the Holding Years the Issuing Corporation used its assets in start-up activities, R&D or in house research, attempt to quantify the value of the assets used in those activities and to document that with declarations and representations.[144]

A.8.5. Obtain declarations and representations as to whether the corporation owned more than 50% (by voting power or by value) of the shares of other corporations during the Holding Years. If so, obtain their tax returns for the Holding Years and include their assets and activities in the active business requirement tests.[145]

A.8.6. From the tax returns for the Holding Years, determine the extent of the Issuing Corporation's working capital needs.[146] If the Issuing Corporation's cash, cash equivalents and investment assets exceed this amount, calculate the year-to-year increases in the Issuing Corporation's working capital needs and identify any steps taken by the Issuing Corporation during the Holding Years to expand the business (such as entering into agreements with real estate professionals, architects, or investment bankers).[147] Obtain declarations and representations to support any positive conclusions.

A.8.7. Is there is any land on the balance sheets in the tax returns for the Holding Years? If so, does it cause the Issuing Corporation to fail the active

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[144] See I.R.C. § 1202(e)(2).

[145] I.R.C. § 1202(e)(5)(A), (C).

[146] Consider applying the "operating cycle" formula to a sample of the Holding Years. See INTERNAL REVENUE MANUAL at 4.10.13.2.5 "Operating Cycle Approach" (2015).

[147] I.R.C. § 1202(e)(6). See text at footnote 34 above. Consider also the "accumulated earnings tax" cases in which corporate officers asserted that accumulated earnings were needed for expansion. See Treas. Reg. § 1.537-1; C. Ngo and J. Warner, ACCUMULATED EARNINGS TAX, Tax Mgmt. Port No. 796 (BNA) at VII (3d ed. 2016).

business requirement?[148] If not, obtain declarations and reps to support this position.

A.8.8. Does the Issuing Corporation receive royalties from software licenses? If so, are the royalties treated as "active business computer software royalties" for personal holding company purposes?[149] If so, obtain declarations and reps as to the foundational facts that support this position.

A.9. **Section 1045 Exclusion and Rollover**

A.9.1. Document the above for both the Sold Shares and the shares acquired by reinvestment. Of course, the date and amount of the reinvestment are critical.[150]

[End of Appendix A.]

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148 I.R.C. § 1202(e)(7). See text at footnote 35 above.

149 I.R.C. §§ 543(d), 1202(e)(8).

150 See Section 3.1(f) and 3.5 above.